shareBUILDER 401K®

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California Secure Choice
Request for Information

From: ShareBuilder 401K by Capital One
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RESPONDENT:

Company:

ShareBuilder Advisors, LLC, an SEC registered investment advisor and subsidiary of Capital One Financial Corporation.

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ShareBuilder Background:

ShareBuilder Advisors, LLC is known in the marketplace as ShareBuilder 401K. ShareBuilder 401K's mission is to help any size business save more money for retirement by simplifying retirement plans. ShareBuilder 401K has focused on serving the under-penetrated, under-served small business market since launch and serves over 3,500 companies across the U.S. The group is a pioneer in:

1. Offering Exchange-Traded Funds (all index-based fund offering) in 401(k) plans since 2005
2. Enabling simple online quote, purchase, and install of 401(k) plans and still today remains one of just a handful of providers that offer this simplicity in buying and setting up a retirement plan
3. Investment fiduciary oversight for employers and managing the investment roster and Model Portfolio offered to employees

ShareBuilder 401K provides one of the lowest cost retirement solutions for small business in the industry. ShareBuilder 401K brings together leading online and offline technologies with a low cost, index-based approach to investing. Our 401(k) plans are supported with fully licensed 401(k) Consultants and Customer Success Managers to help serve employers and participants at the highest level. The ShareBuilder Investment Committee made up of financial experts, including four CFAs, manages the investment roster and model portfolios for our clients, minimizing ERISA fiduciary risks and duties for employers.

The combination of intuitive online videos, setup and guidance materials to participants coupled with real people – our 401(k) consultants – helps provide employees the education they need in the way they consume information to help get them on the right track for retirement. In doing so, we look to reward our customers by helping them save and reach their goals with easy and affordable 401(k) plans.

ShareBuilder 401K's sister company, ShareBuilder, started in 1999 and offers a low-cost approach to helping retail investors save for the long-term. The ShareBuilder Automatic Investor Program enables investors to buy fractional shares of funds and securities they may not otherwise have access to. There are no account minimums or setup fees. This efficient, low-cost platform is well positioned to service an Auto-IRA solution. The units were bought by Capital One in February 2012.

RESPONSES:

1. Plan Structure:

It is generally agreed among experts that employees need to save 10%-15% of their salary over a career to retire at the same level at which they live prior to retirement. Many employees do not have access to retirement plans as they work for small employers without retirement plan benefits. Many don't participate or do not make good decisions as they do not feel confident in selecting funds or know how much to save.

For small businesses, many myths and misconceptions prevent greater adoption of retirement plans. Many believe it is cost and complexity that are the big hurdles facing this marketplace, but our research indicates the top reasons are much different. From our research and experience in the industry, the top five reasons small businesses do not offer 401(k) plans are[1]:

1. Not enough employees to make it worthwhile (48%)
2. Can't afford a company match (23%)
3. Already have another retirement plan in place (14%)
4. Management fees are too high (12%)
5. Our business is to unstable (11%)

In actuality, any size business, even the self-employed can offer a 401(k) plan. Matching is not required in a 401(k) and there are now good low-cost, transparent providers in the space.

To provide the most robust and simple solution for California's small businesses and their employees that will help secure their retirement, we suggest a two-prong offering from multiple providers:

1. Automatic IRA (auto-enrolls employees) preset at 5% of salary with a 1% annual auto-escalation to 10% (employee may override at any time). Starting at 3% of salary is a low level and may not add significantly to an employee's ability to accumulate a meaningful amount for retirement.
2. A low-cost 401(k) offering that takes on the fiduciary status of managing the investment offering for the employers (must be taken on by the provider (an ERISA 3(38) advisor)) that also ensures the State of California has no fiduciary or ERISA accountability.

The determinant of which is the better fit for the business would be based on how much if any the business is willing to pay and how much the business owners and employees would like to save in their accounts (contribution limit). For companies willing to spend $1,000 or so a year for administration and want employees to have the option to save over $5,500 a year, the 401(k) offerings would be presented. For those without budget or no desire to save more, the Auto-IRA provider options would be presented. A simple online form can guide the employer to the right set of options.

We recommend that California chooses (require) only providers that offer a solution that keep employee paid investment expenses (fund expenses, administrative, custodial, asset management, other) less than 1%. High fund and other investment expenses are a big drag on an employee's ability to accumulate adequate savings for retirement. The cost of employees incurring just 1% more in fees can mean the difference of hundreds of thousands of dollars less at retirement. Every dollar paid to fund expenses is one less dollar invested in the markets to build for retirement.

[1]500 firms nationwide with <50employees, June 2013 Wakefield Research / Commissioned by ShareBuilder 401k

With regard to the objective of preservation of principal, this is dependent on the participant's selection of proper funds and also the Plan Provider making sure that they are delivering options that are suited for their audience. It also requires auto-rebalancing to ensure a participants investment do not get overweighted in any one asset class and increase the risk of loss.

Since most participants in these plans will not be financial experts, the fund lineup should reflect this by providing a limited set of diversified, low-expense funds. We recommend that every employee would fill out a simple online questionnaire and would be placed in a low-expense Model Portfolio with auto-rebalancing or Target Date Fund that best fits their risks, time horizon and goals. If the employee does not take the questionnaire the employee would be placed in a balanced or conservative portfolio until they do so. If an employee in the questionnaire proves they are a sophisticated investor, the employee could also be offered a set line-up of low-expense, diversified funds across asset classes to manage their own investments. "Novice" investors could choose to take the questionnaire at any time and graduate to a "sophisticated investor" if that is their desire.

In addition, a robust, automated employee guidance program that educates employees on how much to save for retirement, diversification, tax benefits supported by advisors to answer questions by phone or web or "FaceTime" conferencing would be ideal in helping employees be more confident in taking control of their retirement savings. Online demos, videos, calculators and tools are all important elements to a truly robust program.

To enable portability, the fund allowed must be easily converted to a cash equivalent without penalty and re-invested in a qualified plan or should be able to be rolled directly into a personal IRA. Ideally, if the participant liked their portfolio of funds when they leave their employer they should be able to maintain the funds in the plan or roll these funds directly into a personal IRA without having to change funds. Insurance products like annuities can provide a consistent recurring income string; however, these tend to be very restrictive and not portable options. Once the participant's assets are invested in these funds removing them can be difficult and expensive, especially if changing providers. While an annuity might be the right choice for some of a participant's funds at time of retirement, they may not be the best vehicle to grow assets over the accumulation period prior to retirement.

There are currently providers of low-expense plans that fit these stated objectives within the small business marketplace today. Inventing a new plan structure may not be needed or prudent if available options meet stated objectives.

This Wall Street Journal article is focused on 401(k) plans, but the plan components outlined in the article make sense for any employer sponsored retirement plan and may help in your decision making.

Investment Options:

2. What investments would you recommend?

Provide a limited set of low-expense index funds across essential asset categories and also include Target Date funds or Model Portfolios that a user can select or be automatically enrolled into. Most of the employees that will be in these plans will not be investment professionals so the investments selected should help them limit their risk while providing a diversified investment option. The recommendations in the previous question suggest only sophisticated investors would gain access to the investment roster, and all others would automatically be placed in a Model Portfolio or Target Date fund. Investment options should be diverse, low expense and help should be available to select the right option for the consumer both on and offline. The whole process needs to be easy and simple so that the participant can do this on their own with confidence. An intuitive online process is essential and required to do this in scale for efficiency and ensuring significant costs do not get passed through to these participants.

3. What would a default option be?

A default option will need to be selected. ShareBuilder 401K provides our customers with the option to select between two Qualified Default Investment Alternatives (QDIA); a conservative or balanced Model Portfolio consisting of low-expense index funds. It would likely be best to have the conservative Model as the preset with the Auto-IRA option and let the employer select between two for the 401(k) offering. This allows for diversification that is more likely to protect principal than more aggressive options while keeping the expenses associated with the selection low.

4. Would you recommend including insurance products?

No. Insured interest or insured income funds might be the right choice for a portion of a participant's portfolio at the time of retirement, but these funds are traditionally high-expense funds with low transparency, surrender charges, and are not very portable. Variable and group annuities have historically been particularly troublesome. Portability is one of the main considerations of the CA Secure Choice Plan and a big issue if seriously considering annuities. Also, there are other inherent risks employees may not be aware of. Income stream may change versus what they thought they were promised. If the insurance company has financial trouble this can affect the solvency of the fund as well. For greater perspective, we suggest reading our point of view on Forbes.com.

5. Would you recommend that the plan provide a lifelong string of income?

Most everyone would like a guarantee, but it creates real challenges and why offerings that work to do so have significant flaws. Similar to the answer in 4, the insured/guaranteed lifelong investment vehicles may be the right option for a portion a participant's money in retirement, but they typically are not the best options for accumulating savings due to their traditionally high fees and lack of transparency.

6. Would your recommendations require a change to the Investment Policy Parameters?

We would recommend that more plan options be considered. Limiting the plan contributions to traditional IRA limits and not allowing ERISA / 401(k) plans restricts the ability for more participants to save enough for retirement. Note that we don't consider SEP IRA and Simple IRAs a good alternative for the program due to the employer contribution requirements with these options.

Employees earning less than $55,000 are most likely to save at the amount they are auto-enrolled and this is why we believe a 3% salary deferral is too low. Without auto-escalation they will not get to the 10% deferral level most will need to replace their income during their retirement. Many 401(k) plans offer this functionality already. Those earning more than $55,000 will be unable to save 10% of their salary given IRA contribution limits. If an ERISA plan meets all other stated goals and the State of California is relieved of all ERISA accountability, and the employer for the investment management services of the plan (rather the provider takes it on for the employers), it is a great option for those that are willing to select it.

7. Recommendations for effective risk management

Effective risk management should be part of the fiduciary responsibility of the plan provider – equivalent of the ERISA 3(38) advisor. This is why a limited set of funds and either diversified models or low-expense Target Date funds should be options that are provided to the participants. Investment advisors that take on a fiduciary responsibility to the participants are bound by that responsibility to provide funds that meet employee needs. Providers that offer fiduciary coverage typically have an Investment Committee of certified financial experts, models, and economic data to monitor and manage an effective fund line-up.

8. What would you recommend as the automatic or default investment level

The problem with auto-enrollment levels is that if the salary deferral percentage is small, then the savings is small. However, setting the level too high could adversely impact the employee's ability to pay necessary bills and other costs of living. It is a balancing act.

As previously mentioned, most financial experts suggest that participants should be saving 10% -15% of their earning for retirement. Starting at this level may drive too many employees to opt out. By starting at 5% and auto-escalating 1% a year for the first five years to attain 10% can make a lot of sense to maximize participation and graduate employees to an adequate savings rate.

To further this point, if auto-enrollment is at 3% of salary without auto-escalation, the employee would need to make approximately $183,500 to contribute the maximum allowable in an IRA ($5,500). If the saver's salary is $45,000 that means they would only save $1,350 per year at 3%. Now the saver is better off than they were before they started, but are they really prepared for retirement? We'd suggest it's better than nothing for sure, but not nearly adequate.

9. What options would you recommend for an auto-escalation feature?

An Auto-escalation feature ensures that the deferral percentage grows over time and hopefully aligned with annual increases in salary. The concern with automatic enrollment plans is that users of the plan would set their contribution amount at the automatic minimum and then never reset or increase it. This has been found as a drawback of the automatic enrollment program that is in practice today. Setting an annual increase of 1% that grows to a 10% contribution would gradually get participants to a saving level where most experts suggest participants need to be saving. We believe this or a similar approach will prove successful for California participants.

10. Other design features to consider?

AUTO RE-ENROLLMENT OF OPT OUTS

This would automatically re-enroll any user that opted out the previous year. The employee could still choose to opt out again, but they would need to make that choice. The concern is that if an employee chooses to opt out of the plan, inertia works against them and they have to make the conscious effort to get back into the plan. An automatic re-enrollment feature would remove this inertia and would require the employee to make the conscious effort to not be part of the retirement program each year.

11. What plan design elements would you recommend to minimize leakage?

Portability, education, and perhaps access to funds penalty-free can all help minimize leakage. Enabling loan options whether an employee is with their current employer they started this program with or not, may actually help more employees keep more retirement savings in place. In times of hardship or switching jobs, employees often take out funds and pay the 10% added tax penalty. If loans are portable, even if switching jobs or unemployed, more employees may opt to keep at least the majority of their retirement savings in their retirement account. As they still "payback" the loan to themselves, this money in many cases will be invested again even if there is lost opportunity while the money is out of the market.

12. Provide an Estimate of ongoing administration fees

Expect investment expenses to employees to be under 1% and lower as asset values grow. Components would include investment fund expense ratios and potentially asset management and administrative charges. By leveraging index funds and efficient online and investment management providers, keeping fees low can be obtained no matter the size of the business.

13. Initial startup fees?

Because of the requirements for automated payroll deductions and auto-enrollment for the Auto-IRA option, this plan is more complicated to set up than an ordinary personal IRA. This will require up front work to set up the deduction and enroll participants. A fee may be required to cover these expenses. If needed, the fee should be reasonable for the work involved and should be one-time though it may make sense to spread over a year or more if this charge will be covered by employees.

If paid by employers, to reduce the impact of a government "mandated' program on small businesses, the fees could be off-set by a tax deduction or credit for the year the plan is set up. There should be a limit to the tax credit, but if the credit were reasonable, then we believe that the marketplace would create plans that had a setup fee that either matched or was lower than the tax credit as a marketing component to the small businesses.

14. How would you ensure transparency of fees and expense information?

Fee Disclosure, but something simple that follows a very set format and provides a benchmark to provide context. This chart could be both online and provided in PDF to employers before and after purchase. The 401(k) fee disclosure regulation and document examples the DOL provided were relatively simple and straightforward. However, many providers' disclosures remain difficult to read and to understand defeating the purpose of the regulation. A preset format requirement is a recommendation that could help screen those interested in supporting this program and ensure California participants are provided a great offering

15. How do they get the word out?

California touch points with businesses will be an effective means and advertising may be a consideration. For employees, similar methods should prove effective.

16. Recommendations for managing enrollment, receipt and recordkeeping of payroll contributions and general administration of the plans.

These things can all be managed online but there are expenses associated with this type of work. The Private sector has providers in the small and micro retirement plan market that service these needs. Efficient providers have shown their ability to manage contributions, enrollment and roll-outs in an efficient manner online. Recordkeeping and any required documentation can be provided by the provider via an online interface in an efficient, intuitive manner once the requirements for the program are outlined. A marketplace can be created for these plans and those that choose to be part of the marketplace will compete for the customers, driving down expenses and improving efficiency.

17. Concerns about administering this type of program

Mandating a program on small business will very likely create backlash from this audience and those that are small business advocates. That is why we would suggest a tax credit for any employer paid charge in year one. If the clearing house is implemented, then the setup and any administration type fees would be known by the board. These fees should be audited to make sure that those stated are actually applied. Not all businesses of this size will have payroll, they may do it themselves, and this might also be a challenge to providers that are not set up for this size of customer. There are providers that are focused on this micro market and their products should be considered as ready-made options for the marketplace.

18. Make sure not ERISA

As previously mentioned, as long as California and the employer have safeguards, we do not see that this needs to be a requirement and actually provides greater limitations on the program’s success. There are products that service this micro business market that fall under ERISA and there are products that don’t. There is not necessarily a strong rationale to try and create a new product offering to fulfill this marketplace as these may create issues with federal agencies.

20. Sufficient interest in Retirement Investments Clearinghouse

Yes there would be interest in a marketplace where plan providers are able to provide information on their offering to the businesses of California. If California provides criteria for acceptable features and limits for employer and employee paid expenses, this could enable small businesses to have access to plans that are very, if not more, competitive to plans offered by big businesses.

21. How should the board establish a registration process?

The regulation calls for providers to meet specific requirements to be included in the program; this implies that these providers will be vetted by a State organization. This vetting could open the State up to some risk if one of the vetted companies were to not service their clients in a proper fashion. Some auditing might be required if "membership" to the marketplace is to be managed or maintained. To limit the State's liability outsourcing this process to a third party might be preferred.

The alternative could be to simply require that some sort of plan be in place for companies with 5 or more employees (this needs to be defined) and provide a tax credit to the businesses as the incentive to participate. A penalty could be assessed if a plan is not set up; ongoing enforcement would be limited to the business showing proof of participation (like a proof of insurance). The tax credit should be enough so that it would cover the cost of maintaining the plan.

Another option would be to mirror the state run health insurance marketplaces where consumers are invited to review providers and make their selection. Providers need to meet specific criteria to become and maintain their membership in the marketplace.

24. What should be included in the RFP?

In general, key items should include:

- Anticipated pricing for employer and employees
- Ability to support online purchase and recordkeeping needs with 99% business hour uptime
- Phone service to support employers and employee questions (hours and SLAs)
- Access to advisors to answer guidance questions
- Key components of employee education programs
- Low-expense investments with a goal to keep all-in employee paid expenses under 1%
- Target date fund and/or model portfolio options as part of the investment offering
- Auto-enrollment and auto-escalation capabilities

27. Timeline

The timeline could be shortened by using products already in the marketplace. Require the business provide some sort of program that meets the minimum requirements. Set a 12/31/14 deadline for the plans to start. Again they could use a current product or the marketplace will come up with a new product to fill the need of the California small business person.

The proof of compliance should follow a set guideline and the providers in the marketplace will develop the program to meet the State's requirements.

The less the State is involved the less it is exposed to risk. A State run plan that does not fulfill promises puts the fiduciary risk and blame on the State and opens the State up to potential litigation. However plans that offer to cover the fiduciary risk on existing programs would shoulder this risk, limiting the prospect of liability to the State. The vetting of said companies and ongoing monitoring of the programs would be required; programs would have to remain in good standing to stay within the marketplace.